Funding the Future

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So, the Japanese stock market crash of earlier this week, with its knock-on effects all around the world, was all about panic, and not about substance. The markets have, near enough, recovered. Almost certainly, some people made a great deal from the short-term confusion that arose. And now we are supposed to move on as if nothing happened.

Except that it did. Japanese stock markets did reveal how exposed they are to the risk that the Bank of Japan can create within them by raising interest rates.

US markets demonstrated how vulnerable they are to trades funded with borrowings in Yen.

Other markets showed their capacity to panic.

That does not mean we need to move on. Instead, it demands that we appreciate just how vulnerable the world is to the absurd consequences of permissible decisions by central bankers and others. That vulnerability exists because of the inappropriate assumptions made by some in financial markets that they can act as if there is no risk of change when such risk exists. As a result, they build edifices on the basis of false assumptions.

We saw this in the debacle that the Bank of England created by announcing £80 billion of quantitative tightening in September 2022, which went on to panic markets that had built the so-called LDI trade on the assumption that such a thing would not happen in the way it was announced. The resulting panic brought down Truss. That might have been no bad thing, but it disguised the reality of what happened, which required considerable Bank intervention.

This time, it seems unlikely that any such thing was required: markets worked out they could manage the consequences of the Japnese carry trade changing.

But my point is that irrational market trades, undertaken for pure speculative gain without concern for the underlying supposed use of the assets traded, can have real consequences.

The question is, why do we allow such wholly unnecessary trades to exist when there is no real gain to society from them doing so?

I am not arguing against capital markets per se. I accept that they have a role. I accept that limited trading to provide liquidity for second-hand asset trades is necessary, given the way in which traded securities are issued and redeemed. However, the vast majority of trades in the vast majority of financial markets do not take place to provide finance for anything related to productive activity. They exist to extract speculative profit, and that is a burden on society at large, in my opinion, representing a vast waste of energy, resources and talent for no net gain, whilst creating considerable risk for society at large.

That is the lesson of this week.

It will be forgotten.